International Economics 147 (2016) 1–26

Contents lists available at ScienceDirect

International Economics

journal homepage: www.elsevier.com/locate/inteco

Economic and political determinants of exchange rate regimes: The case of Latin America

Cesar M. Rodriguez [1]

Department of Economics, Portland State University, Portland, OR 97201, USA.

ARTICLE INFO

Available online 21 March 2016

JEL classification:
F33
F55
H80

Keywords:
Political factors
Exchange rate regimes
Latin America

ABSTRACT

This study examines the determinants of exchange rate regime choice between 1985 and 2010 for 20 Latin American countries. The study uses an ordered panel probit that takes into account economic, political and institutional factors. Results indicate that fixed exchange rate regimes in Latin America are associated with small and open economies with respect to trade and financial flows. The larger the tradable sectors are, the less likely it is that a government will peg its currency. Furthermore, the quality of political institutions, political strength and credibility have an influence on how exchange rate regimes are set. Democratic institutions and politically stable contexts are associated with flexible exchange rate regimes, while long tenured governments with more years left in the current term tend to peg their currency. These results seem to support the idea that governments are more concerned about their sustainability than using the exchange rate regime as a commitment device. Finally, results are robust to various specifications and methodologies.

© 2016 CEPII (*Centre d'Etudes Prospectives et d'Informations Internationales*), a center for research and expertise on the world economy. Published by Elsevier B.V. All rights reserved.

E-mail address: cesar.rodriguez@pdx.edu

[1] Tel.: +1 503 725 3943.

http://dx.doi.org/10.1016/j.inteco.2016.03.001
2110-7017/© 2016 CEPII (*Centre d'Etudes Prospectives et d'Informations Internationales*), a center for research and expertise on the world economy. Published by Elsevier B.V. All rights reserved.

1. Introduction

The choice of the most appropriate exchange rate regime has been one of the central discussions faced by academics and policymakers in Latin America for decades. A remarkable number of critical events in Latin America signal the importance of looking at how the appropriate exchange rate regime is chosen. Overall, Latin American countries have witnessed the import substitution era, the foreign debt crisis and its troubled aftermath in the 1980s the sustained growth in the early 1990s, the financial crises in the Southern Cone countries in the 2000s and the post crisis recovery period. Within specific countries, events have illustrated the importance of exchange rate policy: Argentina's adoption of a currency board in 1991, the Mexican and Brazilian currency crises of 1994 and 1999 respectively, Ecuador and El Salvador dollarization processes, Argentina's exit of the currency board in the early 2000s, and Venezuela's multiple exchange rates of the early 2010s. Hence, exchange rate policy has been at the crux of public policy discussions for the region. However, it is not merely an academic curiosity since it conveys broad implications in terms of inflation, trade, monetary policy, and debt sustainability, and it is crucial to financial and regional integration.

After the collapse of Bretton Woods and due to the presumed beneficial effects of pegs on controlling inflation, Latin America experienced a significant increase in the popularity of pegs in the 80s and 90s. However, the currency crises in Mexico, Asia, Brazil and Russia, and increasing capital mobility, questioned their sustainability. The results led to the bipolar view of exchange rate regimes. Eventually, the bipolar consensus that either a floating or a hard peg regime was the key to international stability was disproved when Argentina abandoned convertibility in 2002.[2] Subsequent years witnessed a discussion oriented to more flexible arrangements. But regardless of the specific arrangement, conventional wisdom seems to indicate that the regime choice is endogenous to the local and global economic contexts. In fact, there are no general theories that explain or guide how and why governments choose the currency policies they do, and no empirical work that could consistently state a clear relationship of economic and institutional factors that determine exchange rate regimes in Latin America.[3] Much of the traditional discussion on exchange rate regimes, such as Garber and Svensson (1995), and Obstfeld and Rogoff (1995), focus purely on economic factors as determinants of the regime choice in developed countries. However, the experience of the last forty years suggests that a wide range of internal and external factors affect policymakers' choice of exchange rate regime. For instance, Wise and Roett (2000), Frieden and Stein (2001), and Markiewicz (2006) suggest that domestic political factors influence the choice of exchange rate regimes, and provide detailed insights into the choice dynamics. In other words, without denying the importance of economic factors, it is clear that exchange rate policy is made in a highly political context in which interest groups, electoral and government issues play a major role. The link between economic and political factors is not new for Latin America, and on occasion it has erupted in the form of massive runs on currencies, imposing real costs and economic stress on the countries involved.

The purpose of this study is to demonstrate how Latin American countries incorporate political economy factors in the choice of exchange rate regimes taking into account domestic and international economic features. Most empirical explanations of the determinants of the choice of exchange rate regimes, such as Bayoumi and Eichengreen (1998), and Eichengreen et al. (2003) focus on economic factors related to optimal currency areas and financial integration. Nevertheless, exchange rate policy has differential costs and benefits for economic agents. As argued by Frieden et al. (2010), tradable producers – such as those from the agriculture and industry sector – prefer a flexible regime which lets currency policy to enhance their ability to compete with foreign producers. On the other hand, Broz et al. (2008) survey the evidence on policy preferences and conclude that agents with substantial cross border interests – such as foreign investors, lenders and borrowers – are principally affected by exchange rate volatility and tend to dislike the unpredictability associated with currency

[2] The currency crises in Mexico, Asia, Brazil and Russia, and increasing capital mobility brought the impossible trinity hypothesis to the forefront and resulted in a more bipolar view of exchange rate regimes. Fischer (2001) argues that according to this approach, high capital mobility made intermediate regimes less viable in financially open economies, forcing countries between a pure float or hard peg.

[3] Frieden et al. (2001) is one of the early references followed by Piragic and Jameson (2005).

Download English Version:

https://daneshyari.com/en/article/999116

Download Persian Version:

https://daneshyari.com/article/999116

Daneshyari.com